FILED
AUG 22
CHARLES ELMORE

IN THE

Supreme Court of the United States

OCTOBER TERM, 1951.

No. 267

SOUTHWEST NATURAL GAS COMPANY,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

ARCHIE O. DAWSON,
Attorney for Petitioner,
61 Broadway,
New York 6, N. Y.

Of Counsel:
PAUL SMITH,
DORR, HAND & DAWSON,
61 Broadway,
New York 6, N. Y.

Pandick Press, Inc., 22 Thames St., New York 6, N. Y., U. S. A.

SUBJECT INDEX.

	PAGE
URISDICTION	2
PINIONS OF THE COURTS BELOW	2
TATUTES AND REGULATIONS INVOLVED	2
HE QUESTION PRESENTED	2
UMMARY STATEMENT OF THE MATTER INVOLVED	3
EASONS FOR THE ALLOWANCE OF THE WRIT	9
RIEF IN SUPPORT OF THE PETITION	15
Origin of the "Continuity of Interest" Doctrine	15
The clarification of the definition of reorganization	20
Interpretation of the new statute by the Bureau of Internal Revenue	21
Under the statute here applicable the test as to whether a "merger" is a "reorganization" is not the market value of the stock issued by the continuing corporation but rather whether, considering all the facts, the transaction is a merger of two corporations into a continuing corporation or is a sale by one corporation to another corporation	22
The lower courts have decided this case purely on the arbitrary point of the ratio of the market value of stock issued by the continuing company to the value of the assets transferred rather than considering whether as a matter of substance the transaction was a merger or was a "sell out"	24
Conclusion	31
PPENDIX—STATUTES AND REGULATIONS INVOLVED	32

PAGE

CITATIONS.

Cases:

Gregory v. *Helvering*, 293 U. S. 465 18
Helvering v. *Limestone Co.*, 315 U. S. 179 15
Helvering v. *Minnesota Tea Co.*, 296 U. S. 378 ....5, 9, 10, 11, 12, 17, 19, 21
Helvering v. *Watts*, 296 U. S. 387 ..... 9, 10, 18, 21
LeTulle v. *Scofield*, 308 U. S. 415 ..... 11, 19
Miller v. *Commissioner*, 84 F. (2d) 415 27
Nelson Co. v. *Helvering*, 296 U. S. 374 ..... 9, 10, 18, 21
Pinellas Ice Co. v. *Commissioner*, 287 U. S. 462 16
Roebling v. *Commissioner*, 143 F. (2d) 810; cert. den. 323 U. S. 773 ..... 23, 24

Statutes:

Internal Revenue Code, Sec. 112 ..... 1, 2, 3, 32
Internal Revenue Code, Sec. 1141 2
Revenue Act of 1926, Sec. 203 16
Revenue Act of 1928, Sec. 112 5
Revenue Act of 1934, Sec. 112 ..... 3, 10, 20
United States Code, Title 28, Sec. 1254 1

Regulations:

Treasury Department Regulations 103 ..... 22, 33-35
Treasury Department Regulations 111 ..... 22, 33-35

Miscellaneous:

"The Continuity of Interest Test in Reorganizations", 34 Calif. Law Review 13
H. Rep. 704, 73rd Cong., 2d Sess. 20
Mim. 4555, 1937-1 C. B. 244 ..... 10, 21
Paul, *Selected Studies in Federal Taxation, Third Series* 15
Seidman, *Legislative History of Federal Income Tax Laws* 20

IN THE

Supreme Court of the United States

OCTOBER TERM, 1951.

No. .....

SOUTHWEST NATURAL GAS COMPANY,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

To the Honorable The Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioner, Southwest Natural Gas Company, prays that a writ of certiorari issue to the United States Court of Appeals for the Fifth Circuit to review the judgment of that Court which affirmed a decision of The Tax Court of the United States holding that an admittedly statutory merger to which petitioner was a party was not a reorganization within the meaning of Section 112(g)(1)(A) of the Internal Revenue Code but constituted a sale of the assets of one company to another.

Jurisdiction.

The jurisdiction of this Court is invoked under Section 1254, Title 28, United States Code, and Section 1141(a) of the Internal Revenue Code. The judgment of the United States Court of Appeals sought to be reviewed was entered on May 30, 1951.

Opinions of the Courts Below.

The opinion of the Tax Court is reported in 14 T. C. 81 and is printed at pages 26-41 of the Record.

The opinions of the Court of Appeals affirming the decision of the Tax Court are reported in 189 F. 2d 332. The majority opinion appears at pages 70 to 74 of the Record. The dissenting opinion of Chief Judge Hutcheson appears at pages 74 to 77 of the Record.

Statutes and Regulations Involved.

The pertinent statutes and regulations are printed in the Appendix at pages 32-35, *infra.*

The Question Presented.

Whether the statutory merger of Peoples Gas and Fuel Corporation (hereinafter called "Peoples") with petitioner on December 28, 1940, constituted a sale by Peoples and purchase by petitioner of the assets of Peoples, as determined by the Tax Court and by a majority of the Court of Appeals, or, as contended by petitioner and as concluded by the Chief Judge of the Court of Appeals, constituted a "reorganization" within the meaning of that term as defined by sub-section (g)(1)(A) of Section 112 of the Internal Revenue Code.

Summary Statement of the Matter Involved.

This case involves deficiencies asserted by the respondent in petitioner's income tax for the year 1941 and in its excess profits tax and declared value excess profits tax for the year 1942.

The sole issue is whether the statutory merger of Peoples Gas and Fuel Corporation with the petitioner, effected in December 1940, in accordance with the laws of Delaware, was a sale as asserted by the respondent, or a "reorganization" within the terms of Section 112(g) of the Internal Revenue Code (Appendix, p. 32, *infra*) as contended by the taxpayer. In the determination of this issue there is also involved the broader question of the extent to which the so-called "continuity of interest" test should be applied to statutory mergers and consolidations under the provisions of said Section 112(g) in the light of the significant changes made in that statute by the Revenue Act of 1934. This is an important question which has not yet been considered by this Court.

The decision of the Tax Court, which was affirmed by the Court of Appeals, with the Chief Judge dissenting, sustains the determination of the Commissioner that an admittedly statutory merger was a sale and that, therefore, the tax base of the assets of Peoples cannot be carried over, as in a reorganization, but must be computed anew, as if the assets had been sold, on the basis of the market value of the new securities issued by the petitioner at the date of the merger. Upon the determination of this question depends the proper basis on which the taxpayer is entitled to compute its depreciation deductions and the amount of property paid in for its stock which is to be used in com-

puting its invested capital for the purposes of the excess profits tax.

There is no dispute on the facts of the case which are clearly and fully set forth in the opinion of the Tax Court (R. 28-34).

The merger of Peoples with the taxpayer effected in December 1940 was not a union of two corporate entities which had had no previous business association or community of stockholders; rather, it was a uniting in one corporate entity of two corporations whose business affairs had been operated as an integrated enterprise for many years before the merger (R. 28).

In December 1940 petitioner and Peoples had a common place of business at Shreveport, La., had the same four men as their respective officers, had the same men as principal employees, and, as the Tax Court found, conducted their affairs as an integrated business (R. 21, 28, 33).

The two companies had previously been subsidiaries of the same parent holding company which, in 1935, distributed pro rata to its own stockholders all the shares of its subsidiaries (R. 28).

Both companies were incorporated under the laws of Delaware and they determined, in 1940, to merge under the laws of Delaware. Their reason for so doing was, as stated by the Tax Court, "for the purpose of better integration and greater efficiency" (R. 28, 29, 33).

The Tax Court found as a fact, and the respondent does not contend otherwise, that both companies complied with the procedure for the merger of corporations in Delaware "and pursuant thereto duly effectuated a statutory merger of Peoples with and into the petitioner as the continuing corporation, on December 28, 1940" (R. 35).

Following the merger, petitioner conducted the business as it had been previously conducted. Petitioner's officers and principal employees were the same persons as previously employed (R. 33).

At the date of the merger, individuals who owned approximately 35% of the stock of Peoples also owned approximately 85% of the stock of petitioner. After the merger, these individuals who had owned a substantial amount of stock of Peoples owned approximately 88% of petitioner's outstanding common stock as a result of the stock they received in the merger, plus their prior stockholdings (R. 31, 33).

The controlling stockholders of both companies prior to the merger were the same individuals who owned substantial interests in both corporations. These same individuals continued in active control of the merged business enterprise after the merger (R. 32, 33-34).

This was the transaction which the Tax Court found constituted a sale rather than a merger. There was no deed of sale. The transfer of title was the result of the filing of a Certificate of Merger.

The Tax Court's reason, and the reason of the Court of Appeals, for holding that the transaction was not a reorganization was that the market value of petitioner's common stock issued to the stockholders of Peoples on the merger was small in relation to the value of the assets transferred. The courts below held that under the decision of this Court in *Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378 (1935) (a case which involved the doctrine of "continuity of interest" but a case wherein the statute involved, Section 112(i)(1)(A) of the Revenue Act of 1928, differed in substantial respects from the statute here considered),

an admittedly statutory merger is not a reorganization unless the stock issued to the merging corporation or its stockholders represents, in market value, a substantial part of the value of the assets transferred (R. 39-40, 73-74, 76).

In the present case, however, a merger on the basis of an exchange of stock for stock was impossible because of the large bonded indebtedness of one corporation and the absence of bonded indebtedness of the other. The Tax Court found as a fact:

> "An exchange of common stock for common stock was not feasible because on the basis of market value it would have required 600 shares of petitioner's to equal in the value one of Peoples' and further petitioner's common stock was subordinate to its long term debt and preferred stock outstanding" (R. 31).

Petitioner, immediately prior to the merger, had a heavy bonded indebtedness and an issue of preferred stock, each share of which was then $12.75 in arrears in dividends. Its common stock, of which 566,150 shares were outstanding, had a market value of only 5¢ a share, or an aggregate value for the entire issue of only $28,307.50 (R. 30, 31).

Peoples, on the other hand, had been through the "wringer" of a 77B proceeding as a result of which the holders of all types of stocks, bonds and other securities of its predecessors received shares of common stock of Peoples which remained free of any bonded indebtedness. This common stock at the date of the merger had a market value of $30 per share, or an aggregate value for the entire issue of $533,070. To merge these companies it was, therefore, necessary that the stockholders of Peoples be given appropriate slices of the layers of the capital structure of the company into which it was merged, *i.e.*, a certain per-

centage of the bonded indebtedness and a certain percentage of the common stock. This was done (R. 29, 31).

Accordingly, the Agreement of Merger gave to the common stockholders of Peoples an option to receive in exchange for each share of Peoples either (A) 10 shares of petitioner's common stock and $33 principal amount of petitioner's bonds with a cash adjustment equivalent to 90% of the principal amount of bonds less than $50 denomination, or (B) cash in the amount of $30 per share. All shares of stock of petitioner outstanding at the time of agreement were to remain outstanding; and no new securities were to be issued to the then holders in connection with the merger (R. 31, 32).

Of the stockholders of Peoples at the date of the merger, the holders of 7,690 shares exercised option A and withdrew from the Company, receiving $30 a share or a total of $230,700. Of course, those stockholders who thus elected to receive cash in connection with the merger had a completed transaction and were taxable on their individual gain or loss (R. 32).

The holders of the balance of the shares (59.2% of the total outstanding) exchanged their securities in the merger and received the following:

> $349,350 principal amount of petitioner's 6% first mortgage bonds of the market value of 90¢ on the dollar, or $314,415.
>
> $17,779.50 for fractional bond interests.
>
> 111,850 shares of petitioner's common stock having a market value of 5¢ a share.

Said 111,850 shares of petitioner's common stock represented 16.4% of petitioner's outstanding common stock immediately after the merger transaction was consum-

mated. Immediately thereafter the individuals who had theretofore owned a substantial amount of stock in Peoples, owned approximately 88% of petitioner's outstanding common stock and these same individuals continued in active control of the merged enterprise (R. 32-34).

The Tax Court found: (1) that the transaction here involved was a statutory merger (R. 29-30, 35); (2) that the transaction was undertaken for the business purpose "of better integration and greater efficiency" (R. 33); and (3) that after the transaction the persons who had been in control of the merging company continued in control of the merged company (R. 33).

The Tax Court nevertheless held that this statutory merger was not a statutory merger for tax purposes, solely because the market value of the stock issued on the merger to the stockholders of Peoples, the merging company, was such a small proportion of the value of the assets transferred. The Court of Appeals sustained The Tax Court on the ground that before a statutory merger may be held a reorganization, it is necessary to show that the stock interest issued to the stockholders of the merging company "represents a substantial part of the value of the property transferred" (R. 73).

The issue is well pointed up by the majority opinion and by the dissenting opinion. The majority opinion takes the position that the Court must determine whether a statutory merger was a "statutory merger" for tax purposes solely upon the ratio of market value of stock issued to the value of the assets transferred. The dissenting Judge takes the position that the entire transaction must be looked at to determine whether what was admittedly a "statutory merger" was in essence a sale.

Reasons for the Allowance of the Writ.

The Court of Appeals, with the Chief Judge dissenting, has decided an important question of Federal law which has not been, but should be, settled by this Court.

The Tax Court and the Court of Appeals have decided this case by relying almost entirely on an expression contained in the opinion of this Court in *Helvering* v. *Minnesota Tea Co.,* 296 U. S. 378, a case which involved the doctrine of "continuity of interest" but in which this Court was construing a tax statute which was subsequently radically changed.

In delivering the opinion of the Court in the *Minnesota Tea* case, Mr. Justice McReynolds said, with reference to the stock interest retained by the transferor company's stockholders, "this interest must be definite and material; it must represent a substantial part of the value of the thing transferred" (p. 385). The courts below, applying this formula mechanically and rigidly to the instant case, held that the statutory merger was a sale because of the relatively small market value, at the time of the merger, of petitioner's stock received by the stockholders of Peoples under the terms of the merger (R. 39-40, 73-74, 76).

In the *Minnesota Tea* case and in the companion cases of *Nelson* v. *Helvering,* 296 U. S. 374, and *Helvering* v. *Watts,* 296 U. S. 387, decided the same day, the court was dealing with a statute which defined "reorganization" as including a

> "merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another cor-

> poration, or substantially all the properties of another corporation);" (Revenue Act of 1928, Sec. 112(i)(l)(A)).

In 1934, however, Congress sharply revised the definition of a reorganization, and the portion of the statute which had raised the question presented in the *Minnesota Tea* case and companion cases was now divided into two parts for greater clarity and preciseness. The parenthetical clause was eliminated. This part of the statute was revised to read:

> "The term 'reorganization' means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation, or . . ." (Revenue Act of 1934, Sec. 112(g)(1)).

The difference between the pre-1934 statute and the subsequently enacted statute which is involved in this case is patent, and the fact that the *Minnesota Tea* case and the companion cases of *Nelson* and *Watts* were not binding or applicable under the new statute was recognized by the Commissioner of Internal Revenue in a 1937 mimeograph sent to all Collectors of Internal Revenue and released to the public. This release (Mim. 4555, 1937-1 C. B. 244) said with reference to these decisions:

> "None of these cases is applicable to clause A of the above-quoted provisions of the Revenue Acts of 1934 and 1936, because none of them involved a statutory merger or consolidation" (p. 252).

Nevertheless, in the instant case, the decisions of the Tax Court and of the Court of Appeals are predicated upon the proposition that the formula of the *Minnesota Tea* case under the old statute must be used to determine whether an admittedly "statutory merger" is a reorganization under a statute which now specifically defines a "statutory merger" as a "reorganization".

The development of the "continuity of interest" doctrine to meet the problems raised by the looseness and ambiguity of the old statute was an important contribution by this Court to the Federal tax law relating to corporate reorganizations. We submit that a re-examination of the "continuity of interest" rule with particular reference to the new provision of the statute including "statutory merger or consolidation" in the definition of reorganization is now needed in the interest of the orderly administration of our tax laws and in order to prevent frustration of plain Congressional purpose.

The earlier statute was ambiguous and required judicial construction and limitation. If literally construed it might mean that any acquisition by one corporation of substantially all of the assets of another corporation, even if for a cash consideration, was a reorganization, which would have been clearly contrary to the purpose and policy of the statute. It was to meet this problem that the "continuity of interest" doctrine was evolved to distinguish between an acquisition of assets which was essentially a merger, even though not in the form of a merger, and an acquisition of assets which was essentially a sale. The *Minnesota Tea* case and the other companion cases, and the case of *LeTulle* v. *Scofield*, 308 U. S. 450, also decided under the old statute, were all cases of acquisition of assets of one corporation by another. None of them was a merger as that term is used

in corporation law or as it is used in corporation statutes defining a "statutory merger".

Under the present statute, if the transaction is in form a statutory merger, it would seem that the only remaining question for the Court should be: Was the transaction in substance as well as in form a merger, or was it in substance, despite the form, a sale of the assets by one corporation to another? We recognize that the form of the transaction should not alone be controlling. But in determining the substance of the transaction, should the Courts be limited to the formula laid down in the *Minnesota Tea* case, *i. e.*, that the stock issued—disregarding all other facts —must represent a substantial part of the value of the assets of the merging company?

If this rigid formula is adhered to, it will never be possible for a company without bonded indebtedness to be merged, within the purview of the Federal tax statute, into a company with a heavy bonded indebtedness.

The merger of Peoples with petitioner in the present case was not merely a technical merger but a real merger in the commonly accepted sense with both stock and bonds being issued in such proportions as were demanded by the equities and realities of the situation. There was a real "continuity of interest" for the Tax Court found as a fact that "After the transaction, individuals who had theretofore owned a substantial amount of stock in Peoples, owned approximately 88 per cent of petitioner's outstanding common stock as a result of the stock they received in the merger transaction plus their prior stockholdings in petitioner, and those same individuals continued in active control of the merged business enterprise" (R. 33-34). The majority opinion of the Court of Appeals and the opinion of the Tax Court put no weight in these facts, however, but

hold that "continuity of interest" is not merely a test to see whether the transaction is in reality a merger or in reality a sale but rather a rigid rule which requires that the market value of the stock issued on the merger must represent a substantial part of the value of the assets of the merging company. If such a rigid rule is to be superimposed on the plain language of the present statute, then it should be done by this Court in a decision under the present statute so that businessmen and attorneys planning mergers in the future may know that it is necessary not only to comply with the language of the statute and the substance of the statute but also to have a definite ratio of market value between the stock issued on the merger and the assets of the merging company.

We believe that if this Court should review this case, it would decide that the test as to whether there was a reorganization or sale would be whether there was, in substance, a merger rather than whether some arbitrary ratio of market values had been met.

The desirability of a Supreme Court determination on this matter was well expressed in an article on "The Continuity of Interest Test in Reorganizations" which appears in 34 Calif. Law Review (1946) 1, at page 31. The author states:

> "Since the doctrine is the Supreme Court's creation, only that court can determine where it stops. At least with the definition of 'reorganization' the problem is not one Congress can settle: the problem is whether having spoken Congress will be taken at its word. Since the doubts arise from Supreme Court doctrine, only that court can settle the doubts and it ought to do so as soon as possible. . . .
>
> • • • • • •

> "It is submitted that twenty-four years of uncertainty are enough. The new, precise definition of reorganization says exactly what Congress wanted it to say after years of experience with the faults of the old had showed Congress what improvements were needed. The statute should then be interpreted literally, free of any carry-over from the gloss placed on a deleted portion. A statutory merger should be a reorganization because the statute says it is."

WHEREFORE, your petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this Court directed to the United States Court of Appeals for the Fifth Circuit sitting at New Orleans, Louisiana, commanding that Court to certify and to send to this Court, on a day certain to be therein named, a full and complete transcript of record of all proceedings had in this case to the end that this case may be reviewed and determined by this Court; that the said judgment of the United States Court of Appeals for the Fifth Circuit may be reversed by this Court; and that your petitioner may have such other and further relief in the premises as may be just and proper.

ARCHIE O. DAWSON,
Attorney for Petitioner,
61 Broadway,
New York 6, N. Y.

Of Counsel:

PAUL SMITH,
DORR, HAND & DAWSON,
61 Broadway,
New York 6, N. Y.

Dated: August 22, 1951.

BRIEF IN SUPPORT OF THE PETITION.

Origin of the "Continuity of Interest" Doctrine.

The history of law—whether ecclesiastical or secular—frequently follows a similar pattern. In the beginning, the lawmaker or the priest approves certain principles of conduct which express a basis for proper conduct in the setting in which they are enunciated. In laying down these principles of conduct, words must be used. With the passage of time, the words themselves take on a sanctity even apart from the original context in which they were used. And so, after a while, the rule of conduct becomes a matter of complying with specific words rather than complying with the principles which they were designed to express.

So it has been with the application by the Courts below of the doctrine of "continuity of interest". As this Court has stated, this doctrine was introduced "to eliminate those transactions which had 'no real semblance to a merger or consolidation' (287 U. S. p. 470) and to avoid a construction which 'would make evasion of taxation very easy'." *Helvering* v. *Limestone Co.*, 315 U. S. 179 at 182. It was enunciated as a rule that sought to find the substance of a transaction rather than as a rigid formula having the effect of statute law.

It recognized that the reorganization provisions in the various Internal Revenue statutes were not *tax-exempting* provisions but rather *tax-deferring* provisions. Paul *Studies in Federal Taxation, Third Series,* page 4:

> "Throughout all discussion of corporate reorganization tax law one should keep in mind the thought that the reorganization provisions are, in theory at least, tax-*deferring,* rather than tax-

> *exempting* provisions. This means that reorganizations are deemed by Congress to be transitional, continuing transactions which are not sufficiently 'closed' to justify *economically* (though there may be a different answer on a strict *legal* basis) the imposition of capital gains tax at the immediate moment of an 'ordinary business' transaction."

The earlier statutory definitions of reorganization were so vague and ambiguous that they required judicial limitation to prevent them being utilized as a wide open door to tax evasion. It was out of this situation that the doctrine of continuity of interest arose.

The Revenue Act of 1926, Section 203(h)(1), defined a reorganization as including a

> "merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), "

The looseness of this provision which, if applied literally, would include pure sales for cash of substantially all of the properties of a corporation to another corporation, demanded judicial interpretation and limitation, and the continuity of interest doctrine was the result.

The "continuity of interest" test was first laid down by this Court under the old act in *Pinellas Ice Co.* v. *Commissioner* 287 U. S. 462 decided in 1933. In that case the transaction was not in the form of a merger, but there had been, actually, an "acquisition by one corporation of . . . substantially all the properties of another." In reality it was a sale by one corporation to another of all its properties

for part cash and part short-term promissory notes. The Court said "In substance the petitioner sold for the equivalent of cash" (p. 469) and the Court concluded "the mere purchase for money of the assets of one Company by another is beyond the evident purpose of the provision, and has no real semblance to a merger or consolidation" (p. 470).

About two years later three cases were decided by the Court under this old law on the same day. None of these cases was a "merger" as that term is used in corporation law. The Court was still faced, however, with the provisions of the old act which appeared to include under the definition of reorganization *all* transfers, whether by sale or otherwise, of substantially all the assets of one corporation to another. These three cases were:

Helvering v. *Minnesota Tea Co.*, 296 U. S. 378. In this case a corporation transferred its assets to another corporation for $462,842 in cash and 18,000 shares of common stock valued at $540,000. This transaction was held to be a "reorganization" under the old parenthetical clause, the Court pointing out that the transferor acquired a "definite and material" interest in the affairs of the transferee which represented "a substantial part of the value of the thing transferred". Mr. Justice McReynolds, in giving the opinion of the Court, said (p. 385):

> " 'The words within the parenthesis may not be disregarded. They expand the meaning of 'merger' or 'consolidation' so as to include some things which partake of the nature of a merger or consolidation but are beyond the ordinary and commonly accepted meaning of those words—so as to embrace circumstances difficult to delimit but which in strictness cannot be designated as either merger or consolidation.

> But the mere purchase for money of the assets of one Company by another is beyond the evident purpose of the provision, and has no real semblance to a merger or consolidation. Certainly, we think that to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes.' And we now add that this interest must be definite and material; it must represent a substantial part of the value of the thing transferred. This much is necessary in order that the result accomplished may genuinely partake of the nature of merger or consolidation.
>
> "*Gregory* v. *Helvering,* 293 U. S. 465, revealed a sham—a mere device intended to obscure the character of the transaction. We, of course, disregarded the mask and dealt with realities. The present record discloses no such situation; nothing suggests other than a bona fide business move.
>
> "The transaction here was no sale, but partook of the nature of a reorganization in that the seller acquired a definite and substantial interest in the purchaser."

John A. Nelson Co. v. *Helvering,* 296 U. S. 374. In this case one corporation transferred substantially all its properties to another for $2,000,000 in cash and an entire issue of non-voting preferred stock. The Court held that this transfer constituted a reorganization because the transferor acquired a definite and substantial interest in the affairs of the purchasing corporation even though it secured no voting rights or participation in the management.

Helvering v. *Watts,* 296 U. S. 387. In this case one corporation acquired all the stock of another for some of its common stock and $1,161,184 of bonds. The Court

decided that this transfer of assets for stock and bonds of the transferee corporation was a reorganization. It did not state what proportion of the consideration was represented by the stock.

Following these decisions a number of the lower courts held, under the old statute, that a transfer of assets in consideration of merely long-term bonds of the transferee corporation constituted a retention of an interest in the purchasing corporation sufficient to qualify the transaction as a reorganization. This Court overruled that contention in *LeTulle* v. *Scofield,* 308 U. S. 415 (1940). The Court said that to qualify as a reorganization under the old statute the transferor or its stockholders must be more than a creditor of the transferee and concluded (p. 420):

> "Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee; . . ."

In none of these cases was there in fact a merger. The Tax Court held in the *Minnesota Tea* case that the acquisition of assets in that case was so akin to a merger that it would consider it to be a merger under the language of the statute. Mr. Justice McReynolds in that case said that one of the tests he was using was that the transferor must acquire an interest in the transferee and that this interest must represent a substantial part of the value of the thing transferred; and he found that this substantial value existed in that case. He did not say that this would be a controlling test if there had been an actual merger.

The clarification of the definition of reorganization.

In 1934 Congress took action to eliminate the ambiguity which existed in the reorganization statute. The various Committee reports relating to the Revenue Act of 1934 show that Congress was well aware of the imperfections of the old parenthetical clause and show that the Congressional objective was to get a definition of "reorganization" which would prescribe more precise standards and which would exclude what in reality were "sales".

The House Committee on Ways and Means in commenting on the old law noted that "astute lawyers frequently attempted . . . to take advantage of these provisions by arranging in the technical form of a reorganization . . . what were really sales". The Committee then recommended a change in the laws

> "so that the definition will conform more closely to the general requirements of corporation law, and will limit reorganizations to (1) statutory mergers and consolidations, (2) . . . "

(73rd Cong., 2d Sess., H. Rept. 704, pp. 13, 14; Seidman's *Legislative History of Federal Income Tax Laws,* p. 338).

The section of the statute which had raised the questions presented in the foregoing cases was now divided into two parts for greater clarity and preciseness. The parenthetical clause was eliminated. This part of the statute was revised to read:

> "The term 'reorganization' means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock

of another corporation; or of substantially all the properties of another corporation, or . . . " (Revenue Act of 1934, Sec. 112(g)(1)).

It is to be noted that the new statute provided that a reorganization can be accomplished either by a "statutory merger or consolidation" or by the acquisition by one corporation of substantially all the properties of another corporation. If the transaction is in the form of an acquisition of assets, the sole consideration must be the voting stock of the acquiring corporation. There is no such limitation where there is a statutory merger or consolidation.

Interpretation of the new statute by the Bureau of Internal Revenue.

Following the enactment of this statute, the Treasury Department, in a 1937 release, advised the Collectors of Internal Revenue and the public that the *Minnesota Tea, Nelson* and *Watts* cases were not applicable to Clause (A) because none of them involved a statutory merger or consolidation (*supra,* p. 10).

In the instant case, we have a situation where taxpayers were advised by a published opinion of the Treasury Department that the *Minnesota Tea* case was not applicable to Clause (A) of the statute and then, after the transaction is consummated, the taxpayer is now told by the Tax Court that an admittedly statutory merger is not a merger because the language of the *Minnesota Tea* case—that the stock issued by the mergee corporation must represent a substantial part of the value of the thing transferred—is still applicable to this provision of the statute.

The regulations promulgated by the Commissioner of Internal Revenue do not set any such arbitrary test. The

regulations simply require "a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization" (Appendix, *infra*, p. 33). Obviously if those who were owners of the enterprise have no continuing interest in the merged enterprise it may be held that they have "sold out" and that the transaction was in reality a "sale" and not a "merger" despite any legal formalities which were followed. Whether they have this continuing interest is a question of fact, however, and not of applying a ratio of values.

Thus the regulations specifically provide:

> "The Code recognizes as a reorganization the amalgamation (occurring in a specified way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and securities of either of the old corporations the requisite continuity of interest in the new corporation, but there is not a reorganization if the holders of the stock and securities of the old corporation are merely the holders of short-term notes in the new corporation" (Appendix, *infra*, p. 33).

Under the statute here applicable the test as to whether a "merger" is a "reorganization" is not the market value of the stock issued by the continuing corporation but rather whether, considering all the facts, the transaction is a merger of two corporations into a continuing corporation or is a sale by one corporation to another corporation.

By including "statutory merger" in the definition of reorganization Congress unquestionably meant to include all statutory mergers except, perhaps, a statutory merger which, although permitted by a State statute, was clearly beyond the pale of the common concept of "merger".

There has been only one other case which has arisen since the present definition of "reorganization" has been in effect where the court has found that a "statutory merger" was not a "reorganization". This was the case of *Roebling* v. *Commissioner*, 3 Cir., 143 F. 2d 810; *cert. den.* 323 U. S. 773. In that case the two corporations complied literally with the New Jersey law relating to mergers but the stockholders of one of the corporations received in exchange for their stock only long-term bonds of the continuing corporation. They had no participation in the management of the continuing corporation. It was exactly as if they had sold out their interest for cash but instead of cash they received long-term obligations. They had had no previous connection with the management of the continuing corporation; they had no subsequent connection with the continuing corporation except as creditors. The court held that despite this technical compliance with a merger statute, the absence of any continued proprietary interest on the part of the stockholders of one corporation in the continuing corporation made the transaction in reality a sale by them of their interests and not a merger.

The factual background in the instant case is quite different. In the instant case there had always been a community of interest between the proprietors of the two corporations. The Tax Court found as a fact that before the merger the two companies had "conducted their affairs as an integrated business" and that following the merger the business was conducted "as it had been previously conducted" (R. 33). The Tax Court found as a fact that the same individuals who had controlled the two companies prior to the merger and who had large stock interests in both, after the merger "continued in active control of the merged business enterprise" (R. 32, 34).

In the instant case, unlike the *Roebling* case, there was no selling out of the interests of the proprietors but rather a continuance of this interest and a continuity of this control in the continuing corporation.

It is apparent that the "continuity of interest" doctrine was not laid down by this Court as a rigid rule of law but rather as a pragmatic test to distinguish between a transaction which is in essence a sale and a transaction which is in essence a merger or consolidation.

Obviously, if those who were the owners of an enterprise have no continuing interest in the merged enterprise, it may be held that they have "sold out" and that the transaction is in reality a "sale" and not a "merger" despite any legal formalities that were followed. However, if the transaction in the instant case was not a bona fide merger but in reality a sale, the facts so indicating should be clear and the decision should be based on those facts rather than an arbitrary ratio of values.

The lower courts have decided this case purely on the arbitrary point of the ratio of the market value of stock issued by the continuing company to the value of the assets transferred rather than considering whether as a matter of substance the transaction was a merger or was a "sell out".

Since Congress has directed that a "statutory merger" shall be treated as a "reorganization", the only proper test for a court to use is: Was the transaction, in substance, a true merger or was it a device or scheme to conceal a sale?

This issue has not been met by the courts in the present case. The lower courts, disregarding all other facts, say that there cannot be a merger unless the market value of

the stock issued on the merger—ignoring any other securities issued—is a substantial part of the value of the assets transferred. There is no statutory basis for such a test. The test should be whether on all the facts the transaction was a bona fide merger of the two corporations into a continuing corporation or whether it represented a "sell out" by one corporation, or its stockholders, to another corporation.

This case is entirely different from the situation where two distinct groups of stockholders own two distinct corporations which they merge. In the present situation the same group of individuals owned a substantial part of the stock of both corporations. The community of interest between those who were stockholders of the two corporations goes back to the time when the predecessors of both corporations had been subsidiaries of one holding company which in 1935 distributed the stock of the subsidiaries to its own stockholders. While certain changes in common stockholdings took place between 1935 and the date of the merger due to sales of stock by some stockholders and changes resulting from the 77B reorganization of the predecessors of Peoples, nevertheless at the date of the merger individuals who owned approximately 35% of the stock in Peoples also owned approximately 85% of the stock of petitioner (R. 31). Likewise, the controlling stockholders were individuals who owned substantial stock interests in both corporations (R. 32). The same individuals were the officers of both corporations (R. 33).

In 1940, the merger of the other operating companies having by then been effected, consideration was given to merging the two remaining operating companies into one corporate unit so as to conform to the business realities,

inasmuch as they were operating at the time in effect as a single business unit (R. 33).

The practical problem of distribution of securities on the merger was given careful consideration (R. 46). This problem was not easy of solution because of the contrasting nature of the capital structures of the two companies (R. 31). Petitioner had large bonded indebtedness outstanding and its common stock had a market value at the time of only five cents a share; the market value of the entire outstanding common stock of petitioner at the time was only $28,307 in the aggregate (R. 31). Peoples, on the other hand, had come out of the 77B reorganization with no bonded indebtedness and its capital was represented only by common stock which had a market value of $30.00 a share, or $533,070 market value for the entire issue of stock (R. 31).

Obviously, in such circumstances, an exchange merely of stock for stock was impossible. If there was to be any statutory merger of these companies at all it was necessary that the stockholders of Peoples be given a substantial portion of the bonded indebtedness as well as a substantial proportion of the common stock of the continuing corporation. This is what was done.

That there was a substantial continuity of proprietary interest after the merger is shown by the following:

1. After the merger individuals who had owned stock of Peoples thereafter owned approximately 88% of the stock of the merged corporation (R. 33). It might be claimed that the stockholders of Peoples received only 16.4% of the stock of the merged corporation for the stock which they held in Peoples, but it must be remembered that stockholders of Peoples had also owned stock in petitioner,

so that when the merger was over these individuals, to wit, former stockholders of Peoples, owned—by virtue of their prior holdings in Peoples and in petitioner—88% of the stock of the continuing corporation (R. 33).

2. After the merger the same group of individuals who had previously been in control of the two constituent corporations controlled the continuing corporation (R. 34).

3. No change in business operations took place as a result of the merger. The officers remained the same individuals (R. 33). The engineers, lawyers and accountants remained the same individuals (R. 33, 47). The operations were conducted exactly as they had been before (R. 47).

This simplification of the corporate structure of utility companies was in conformity with the national policy looking toward that end. It was also in conformity with the very purposes of the reorganization and exchange provisions of the Internal Revenue Code. It was an amalgamation of closely affiliated business enterprises and not a sale.

The fact that some stockholders received cash, and, in effect, withdrew from the company, did not make it any less true that the two corporate entities themselves were merged and were not sold one to the other. Of course, those stockholders who elected to receive cash in connection with the merger had a completed transaction and were taxable on their individual gain or loss. But so far as the corporations were concerned, Peoples was not selling its assets to petitioner; it was merging the assets and the business. In *Miller* v. *Commissioner,* 6 Cir., 84 F. (2d) 415 (1936), the Court said (pp. 418-419):

> "We attach no importance to the fact that some of the stockholders in the transferring corporation

> acquired no interest in the transferee. This is certainly not a test by which the effectuation of a merger or consolidation is to be determined, for it will rarely result when reorganizations, even in their strict literal sense, are undertaken that all stockholders will approve. It is almost universal experience that some non-assenting stock must be acquired otherwise than through the mechanics of the consolidation plan . . . The transaction between the two corporations was a merger or consolidation within the statute."

As a result of the merger the stockholders of Peoples received $349,350 principal amount of bonds of the petitioner out of a total long term indebtedness of $2,923,950 and received 111,850 shares of common stock out of 678,000 shares outstanding (R. 32, 41).

If the intention had been for this transaction to be a sale, obviously substantially all the stockholders of Peoples would have exercised the option granting them the right to receive cash for their stock. They did not do so. They elected to continue in the continuing company. In doing so, they received their proportionate share (based upon the proportionate asset value of the two corporations) of the common stock and of the mortgage bonds of the continuing corporation.

The stock interest percentage-wise was substantial. It represented 16.4% of the voting stock of the continuing corporation and 16.4% of the equity interest in the corporation represented by common stock. The dissenting opinion of Chief Judge Hutcheson points up the fallacy of distinguishing between a merger and a sale solely on the basis of the market value of the stock issued at the time of the merger. Judge Hutcheson aptly states:

"The opinion of the tax court and that of the majority pinpoints the difficulty with petitioner's claim as arising, not out of the smallness of the number of the shares of the common stock of petitioner received by the stockholders of the transferor, but out of the smallness of their market value. This holding of the tax court does complete violence to the whole fact and theory of the difference, in respect of corporate ownership and control, between the ownership, on the one hand, of common stocks having voting power, power of management and ownership of the equity interest in the corporation, and, on the other, the ownership of bonds or notes having no voting power, no power of management, and no ownership in the equity.

"The decision and order completely ignore these controlling facts: that Peoples, the transferor, had come out of a 77B reorganization with no bonded indebtedness and a capital represented only by common stock, while the petitioner had a heavy bonded indebtedness which depressed the present value of its stock to five cents a share.

"With deference, again, this is to completely ignore the fundamental facts of corporate investment, corporate life and growth in this country. These are: (1) that the equity, the common, stock ownership in a growth corporation, which grows and prospers with the corporation's growth and prosperity, is the important interest to hold; (2) that in any well managed growth organization, therefore, the ownership and control of its common stock, rather than that of its bonds, its notes, or its preferred stock, is what counts for the most; and (3) that in such a corporation what is most important at a particular time is not what the common stock may be then selling for but the control, and the future, of the equity interest" (R. p. 76).

If the 16.4% of common stock issued on the merger had, at the time, a market value of only $5,592.20 (R. p. 73), this is merely a way of stating that the market value at that time of the entire outstanding issue of common stock was only $33,900.

Nevertheless, this common stock represented 16.4% of the voting control of the Company and the opportunity to participate proportionately in the future growth of the continuing company. A substantial participation in voting control and in the right to participate in future growth has an intrinsic value quite apart from prices paid in the market on sales of a few shares of stock.

That this equity interest was definite and material can be seen from the fact that this same common stock, in 1949, had a market range of between $2.875 and $5.50 per share as shown in the public records of stock quotations. (Moody's Manual of Investments, Public Utilities, 1950; p. 545.) The value of this common stock has grown until it exceeds by many times the value of the bonds which were issued on the merger.

Where stockholders receive *only* cash or bonds payable at a fixed dollar amount, it is obvious that they retain none of that speculative equity interest in a company which would be represented by stock; and in such a situation the courts might properly conclude that they have, in effect, sold their stock for a fixed dollar amount. However, where the stockholders also receive their proportionate share of the equity interest, whatever that interest may be, they continue to have a definite proprietary interest in the enterprise for they share in the return from, and the growth in, the equity interest as well as retaining an additional interest secured by their bonds.

Any business man—and we believe any lawyer— looking at this transaction in its entirety, would conclude that it was not merely in form a statutory merger but that it was in substance a merger and that it bore no resemblance to a sale. We believe that this Court, which is responsible for the "continuity of interest" doctrine, should not allow a strained and formularistic application of that doctrine to transform a merger into a sale in cases such as this where the facts show so clearly that a merger and not a sale has taken place.

Conclusion.

It is therefore respectfully submitted that this case is one calling for the exercise by this court of its supervisory powers, by granting a writ of certiorari and thereafter reviewing and reversing the decision of the Court of Appeals.

Respectfully submitted,

Archie O. Dawson,
Attorney for Petitioner,
61 Broadway,
New York 6, N. Y.

Of Counsel:

Paul Smith,
Dorr, Hand & Dawson,
61 Broadway,
New York 6, N. Y.

Dated: August 22, 1951.

Appendix.

Statutes and Regulations Involved.

Internal Revenue Code (provisions as effective for tax years 1941 and 1942):

Sec. 112 (g)

"(g) Definition of Reorganization.—As used in this section and section 113—

(1) The term 'reorganization' means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation, or (C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, or (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (E) a recapitalization, or (F) a mere change in identity, form, or place of organization, however effected.

(2) The term 'a party to a reorganization' includes a corporation resulting from a reorganization and includes both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another."

Treasury Regulations 103 and 111.

Sec. 19.112(g)-1 of Regulations 103 (applicable to year 1941) and Sec. 29.112(g)-1 of Regulations 111 (applicable to year 1942):

"*Purpose and scope of exception of reorganization exchanges.* . . .

Purpose: Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. The Code recognizes as a reorganization the change (made in a specified way) from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a subsidiary corporation, but not the creation of a temporary subsidiary as a device for the making of an ordinary dividend. The Code recognizes as a reorganization the amalgamation (occurring in a specified way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and securities of either of the old corporations the requisite continuity of interest in the new corporation, but there is not a reorganization if the holders

of the stock and securities of the old corporation are merely the holders of short-term notes in the new corporation. In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule. Accordingly, under the Code, a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up.

Scope: The nonrecognition of gain or loss is prescribed for two specifically described types of exchanges, viz: The exchange that is provided for in section 112(b)(3) in which stock or securities in a corporation a party to the reorganization are, in pursuance of a plan of reorganization, exchanged for the stock or securities in a corporation a party to the same reorganization; and the exchange that is provided for in section 112(b)(4) in which a corporation a party to the reorganization exchanges property, in pursuance of a plan of reorganization, for stock or securities in another corporation a party to the same reorganization. Section 112(g) limits the definition of the term 'reorganization' to six kinds of transactions and excludes all others. From its context, the term 'a party to a reorganization' can only mean a party to a transaction specifically defined as a reorganization by section 112(g). Certain rules respecting boot received in either of the two types of exchanges provided for in section 112 (b) (3) and (4) are prescribed in section 112(c) and 112(d). Under section 112(i) a limitation is

placed on all these provisions by providing that except under specified conditions foreign corporations shall not be deemed within their scope.

The provisions of the Internal Revenue Code referred to in the preceding paragraph of this section are inapplicable unless there is a plan of reorganization. A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 112(g) and for the bona fide consummation of each of the requisite acts under which non-recognition of gain is claimed. Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme which involves an abrupt departure from normal reorganization procedure, devised and adopted with reference to a transaction on which the imposition of the tax is imminent, is not a plan of reorganization."

Sec. 19.112(g)-2 of Regulations 103 and Sec. 29.112 (g)-2 of Regulations 111:

"*Definition of terms.* . . .

The application of the term 'reorganization' is to be strictly limited to the specific transaction set forth in section 112(g)(1). The term does not embrace the mere purchase by one corporation of the properties of another corporation, for it imports a continuity of interest on the part of the transferor or its stockholders in the properties transferred. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short-term notes, the transaction is a sale and not an exchange.

The words 'statutory merger or consolidation' refer to a merger or a consolidation effected in pursuance of the corporation laws of the United States or a State or Territory or the District of Columbia."